The Learning Corner: Direct Purchase Non-Bank Qualified Bond Pricing By Banks

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Preface

In a number of states we estimate that as many as 30% or more of Qualified Small Issue bonds for manufacturers and other non-bank qualified bonds are purchased directly by commercial banks. In other states, particularly smaller states, few, if any, banks are involved in direct purchase programs. To help issuers recruit banks for direct purchase programs, this article offers a formula to help banks price non-bank qualified bonds. If you would like to contribute an article to the Learning Corner or comment on others, please contact Stan Provus at (501) 760-6000 or provus@hsnp.com

Direct Purchase

The direct purchase of non-bank qualified, private activity bonds by commercial banks may be an attractive method of sale, particularly for smaller bond issues in the $500,000-$2 million range. With this approach, an issuer directly places bonds with a commercial bank. Professional fees, which can make smaller deals uneconomical, are substantially reduced because there is typically no placement agent, remarketing agent, letter of credit bank (and all their additional associated legal fees), rating, and possibly no trustee (or the bank that purchases the bonds will act as trustee and paying agent) as well on these transactions. On the other hand, bond pricing is higher but offset by the lower fees that can have a significant impact on the effective cost of borrowing for smaller deals.

What Bank-Qualified Bonds Means (Kurt Froehlich said the following about bank qualified bonds in an earlier article).

Not all issuers can issue so-called "bank qualified bonds." Subject to certain exceptions, those issuers would be those, which in the applicable calendar year would not reasonably anticipate issuing more than $10,000,000 of tax-exempt obligations (including only non-private activity bonds (i.e. governmental bonds) and qualified 501(c)(3) bonds, but excluding all other types of private activity bonds). The common reference to this is that such bonds would be "bank qualified", since banks and other financial institutions derive a larger deduction for interest purchase and carrying costs than would otherwise apply. (Because of the odd term, bank qualified, some banks even mistakenly believe that they cannot purchase and hold non-bank qualified bonds. It is just an interest rate question).

Because larger issuing finance agencies typically issue significant amounts of qualified 501(c)(3) bonds for, among other purposes, health care and educational facilities, such agencies usually can not issue bank qualified bonds.

How United Bank In DC Prices These Bonds

At CDFA's recent Development Bond Finance Course, Tom Nida of United Bank in Washington, DC. Provided the following formulas for pricing both non-bank qualified and bank qualified tax-exempt bonds.

Interest Rate Formula for Non-Bank Qualified Bonds

(Index + Spread) X (1-Purchaser's Tax Rate) Plus
(Purchaser's Cost of Funds) X (Purchaser's Tax Rate)

Example: In this example it is assumed the 'Index" is one-month LIBOR which has been about 3.5% recently. LIBOR is a common Index for floating rate debt. The 'Index" for fixed rate issues could be treasuries of similar maturity. The 'Spread" is what a bank typically charges a borrower in addition to the Index—many borrowers are quoted a taxable rate of one-month LIBOR plus 150 to 250 basis points—here we assume a Spread of 200 basis points. The example further assumes the bank's tax rate is 35% and their cost of funds is 3.5%.

(3.5 + 2.0) or 5.5 X (1-.35) or .65= 3.575 (5.5 X .65)
PLUS
3.5 x .35=1.225. Thus, 3.575 + 1.225= 4.8%

In this example, the bank would purchase the non-bank qualified bonds for 4.8%.

Interest Rate Formula for Bank Qualified Bonds

(Index + Spread) X (1-Purchaser's Tax Rate) Plus
(Purchaser's Cost of Funds) X (Purchaser's Tax Rate) X (.20)

In this example for a bank-qualified deal, we make the same assumptions as above for a non-bank qualified deal.

(3.5 + 2.0) or 5.5 X (1-.35) or .65= 3.575 (5.5 X .65)
PLUS
3.5 x .35=1.225 X .20= .245. Thus, 3.575 + .245 = 3.82%. In this example, the bank buys the bank-qualified bonds for 3.82 % or about 1% less than non-bank qualified bonds.